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The Fed's New Model of Supervision for "Large Complex Banking Organizations": Coordinated Risk-Based Supervision of Financial Multinationals for International Financial Stability

Cynthia Crawford Lichtenstein*

Ever since the Asian financial crisis in the late 1990s,¹ there has been considerable debate among academic scholars concerning an appropriate structure for overseeing the multinational purveyors of international financial services.² The proposed structures differ significantly. On one hand, there is the present so-called international financial architecture³ of intergovernmental committees with no discernible personality in international law. Committees such as the Basel Committee on Banking Supervision ("BCBS")⁴, International Organization of Securities Commissions ("IOSCO")⁵ and the International Association of Insurance Supervisors ("IAIS")⁶ produce sets of "principles" or "best practice standards" on regulation and supervision having no legal force until enacted domestically.⁷ On the other hand, there is a proposal for an international agreement to implement harmonized standards⁸ and proposals for a global regulator.⁹

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1. See Cynthia Crawford Lichtenstein, *Dealing with Sovereign Liquidity Crises: New International Initiatives for the New World of Volatile Capital Flows to and from Emerging Markets*, 29 MCGEORGE L. REV. 807 (1998) (describing the origins of this crisis from the point of view of an academic interested in the interconnections between bank safety and soundness and international financial stability).

2. See JOHN EATWELL & LANCE TAYLOR, *GLOBAL FINANCIAL RISK* (New Press 2000).

3. See THE REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE (Rosa Lastra, ed., 2001) (providing a collection of essays on this "architecture").

4. The Basel Committee on Banking Supervision, at <http://www.bis.org/bcbs> (last visited June 26, 2005).

5. International Organization of Securities Commissions, at <http://www.Iosco.org> (last visited June 26, 2005).

6. International Association of Insurance Supervisors, at <http://www.laisweb.org> (last visited June 26, 2005).

7. See Herbert V. Morais, *The Quest for International Standards: Global Governance vs. Sovereignty*, 50 KAN L. REV. 779 (2002) (describing the three "organisations" listed as well as a complete catalogue of other international standards and their formulations in 2002).

8. Mario Giovanoli, *A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting*, in INTERNATIONAL MONETARY LAW: ISSUES FOR THE NEW MILLENNIUM (Mario Giovanoli ed., 2000). *Contra* Cynthia Crawford Lichtenstein, *Hard Law V. Soft Law: Unnecessary Dichotomy?* 35 INT'L LAW. 1433 (2001).

9. See EATWELL & TAYLOR, *supra* note 2, at 208 (proposing to create a "World Financial Authority").

The general question of whether nonbinding "standards" can achieve an adequate level of compliance with international norms in any particular area of international concern (for example, the environment, the international financial system, oversight of nuclear proliferation) has spawned at least two important books: "The New Sovereignty" by Abram and Antonia Chayes¹⁰ and a collection of significant essays by international law commentators titled "Commitment and Compliance: The Role of Non-binding Norms in the International Legal System."¹¹ This theoretical literature agrees on one fundamental proposition: the safety and soundness of the internationally active financial conglomerates¹² that link together¹³ the economies of both the industrialized countries and the emerging market countries into one global financial system are paramount to international financial stability.

This belief in the necessary safety and soundness of internationally active financial conglomerates for global financial stability is based upon the general understanding of what is labeled "systemic risk"¹⁴ ("SR"). As will be discussed subsequently,¹⁵ the U.S. central bank, which is the Board of Governors of the Federal Reserve System ("the Fed") and presently has supervisory functions for certain types of depository institutions in the United States, including foreign banking organizations in the United States, and is also the so-called "umbrella" supervisor for the "financial services holding companies" authorized in 1999 by the Gramm-Leach-Bliley Act.¹⁶ The Fed regularly issues so called "Supervisory Letters" to its examiners, supervisory officers at the regional Federal Reserve

10. ABRAM CHAYES & ANTONIA HANDLER CHAYES, *THE NEW SOVEREIGNTY: COMPLIANCE WITH INTERNATIONAL REGULATORY AGREEMENTS* (1995).

11. OXFORD UNIVERSITY PRESS, *COMMITMENT AND COMPLIANCE: THE ROLE OF NON-BINDING NORMS IN THE INTERNATIONAL LEGAL SYSTEM* (Dinah Shelton ed., 2000).

12. Note that the term used here is "financial conglomerates" rather than internationally active "banks." As has been well written about by Joseph Norton & Christopher Olive, *A By-Product of the Globalization Process: The Rise of Cross Border Bank Mergers and Acquisitions—The U.S. Regulatory Framework*, 56 BUS. LAW. 591 (2001). That is, the consolidation of the large enterprises, whenever headquartered, engaged in cross-border financial services has created a new class of financial services providers that dominate the global financial markets. Since the repeal of the Glass-Steagall Act (13 U.S.C. §§ 24, 78, 377-78 (1994)) repealed by the Gramm-Leach Bliley Act, Pub. L. No. 106-102, 1338 (1999) (codified in scattered sections of 12 and 15 U.S.C.), the very large U.S. banks as Morgan-Chase and Citibank themselves the products of the wave of banking mergers in the United States, have to group together under one "financial services holding company" a combination of banking, securities and insurance services to rival the largest of the financial conglomerates headquartered in other industrialized countries, regardless of whether those conglomerates are primarily banking firms securities firms or insurance firms.

13. Space prevents a description of the linkages themselves. Trouble in the Clearing House International Payments System (CHIPS) from the Herstatt affair is often cited as the original cause of the formation of the Basel Committee on Banking Supervision.

14. It must be acknowledged that not all commentators on the international financial scene believe in the existence of "systemic risk," or at least that such risk might be occasioned by the failure of one of the conglomerates. See, e.g., HAL SCOTT, *INTERNATIONAL FINANCE: TRANSACTIONS POLICY AND REGULATION* (11th ed. 2004).

15. *Id.*

16. See *supra* note 12 and accompanying text.

banks, and the domestic and foreign banking organizations it supervises. Each Letter is identified by an SR number for the Division of Banking Supervision and Regulation of the Fed.

On May 28, 2003, the Fed issued a supervisory letter ("SR letter"),¹⁷ attaching an Interagency Paper providing guidance ("sound practices") agreed upon by the Fed, the U.S. Securities and Exchange Commission ("SEC"), and the Office of the Comptroller of the Currency (the primary supervisor for the U.S. federally chartered banks or "national" banks) for the supervision of (1) "... organizations that are deemed to present a type of systemic risk to U.S. financial markets . . ." (subsequently described as "core clearing and settlement organizations") and (2) financial institutions "that play significant roles in critical financial markets." The SR letter described these two types of organizations as "... pos[ing] higher degrees of systemic risk should they be unable to recover or resume critical activities that support critical markets."¹⁸

The SR letter defines the term "systemic risk," associated with the first type of organization, as:

the risk that the failure of one participant in a transfer system or financial market to meet its required obligations will cause other participants to be unable to meet their obligations when due, causing significant liquidity or credit problems and threatening the stability of financial markets. The definition is drawn from a glossary of terms used in payment and settlement systems. Committee on Payment and Settlement Systems, Bank for International Settlements (2001).¹⁹

Both the SR letter and the attached Interagency Paper define "firms that play significant roles in critical financial markets," the second type of organization mentioned above, as those that "... clear or settle at least five percent of the value of transactions in a critical market."²⁰ The Interagency Paper then declares the "critical financial markets" to include the markets for federal funds, foreign exchange, commercial paper, U.S. government and agency securities, and corporate debt and equity securities.

To translate the Interagency Paper, the Fed, the SEC and the Office of the Comptroller of the Currency are announcing publicly that a firm participating in, clearing or jointly setting at least five percent of the value of transactions in one of the above listed markets that fails to meet its obligations as they become due, threatens the stability of the U.S. financial system. The Interagency Paper

17. FRB: Supervisory Letter SR 03-9 on Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System (May 28, 2003), at <http://www.federalreserve.gov/boarddocs/SRLETTERS/2003/SR0309.htm> (last visited June 26, 2005).

18. *Id.* ¶ 1.

19. *Id.* ¶ 4.

20. *Id.* ¶ 1.

suggests preparing back-ups for wide-scale disruption event. Indeed, the Paper was prepared because of the September 11, 2001 ("9/11") terrorist attacks. Nevertheless, the Letter and its attached Interagency Paper imply that a single "large" (as defined) firm's insolvency could cause great havoc in both the domestic and the international financial markets.

At this point, one may ask why is this SR letter and Paper addressing financial market disruption when that is just the function normally taken on by any country's central bank or other agency assigned the lender-of-last-resort ("LOLR") function in the economy. Indeed, in the afternoon of 9/11, the Fed, the Bank of England and the European Central Bank (which, not having clear LOLR authority itself, had convened by telephone all eleven of its national central banks) all issued press releases assuring the markets that each Bank stood ready to provide whatever liquidity the markets needed to ensure that the 9/11 tragedy did not cause an international financial system failure. The Banks coordinated successfully because the Fed of New York, acting with Chairman Greenspan, heroically called its counterparts in London and Frankfurt to make arrangements necessary to calm the critical international markets.

Unfortunately, however, in the case of a threat to the international system from the failure of one huge multinational financial conglomerate, determining which sovereign's LOLR will lead the "bailout" is not so obvious. The Basel Concordat²² delineates supervisory authority to the central bank "responsible" for the insolvency of a multinational bank present in more than one country. However, it does not obligate any central bank to support the delinquent institution. Indeed, for the first years of its existence, the Concordat was not published for fear of encouraging "moral hazard."

Thus, we are left with the question: if certain large multinational financial institutions responsible for more than five percent of the transactions in the federal funds (a huge interbank dollar market), foreign exchange, commercial paper, government bond, corporate debt, or equity securities markets present "systemic risk" to the international financial system in the event of failure, how does the "international community"²³ ensure "the safety and soundness" of these conglomerates? It is at this point that I lay bare my conviction that the theoretical debate as to the legal nature of the rules is unhelpful. Instead, what is helpful is analyzing how effective supervisors are at overseeing these conglomerates. Since the business of these conglomerates is complex financial engineering, they need sophisticated oversight. Also important is ensuring that supervisors cooperate when overseeing the conglomerate's business units, wherever located.

22. Basel Committee: Principles for the Supervision of Banks' Foreign Establishments-Basle Concordat (May 1983), at <http://www.bis.org/publ/bcbasc312.pdf> (last visited June 26, 2005).

23. Forgive the author for using a term so long out of use. I was educated at a time when that was the term used to mean the *cooperation* of states to ensure that all those economic entities under each state's jurisdiction were subject to regulation for whatever was the agreed upon "common good."

At this point it is necessary to discuss the difference between “regulation” and “supervision.”²⁴ This difference might seem to present a tangential discussion, but does not. Consider the ordinary business corporation in jurisdictions with capital markets. If it raises capital by issuing securities to the public, it is subject to regulation by the securities regulators who have jurisdiction over the corporation pursuant to legislation or a supranational²⁵ entity that purports to be prescribing the regulation. A government proscribes the penalty to be imposed upon corporate entities for violating applicable regulations (civil or criminal), and in some cases, such as mutual funds (which, after all, are only ordinary business corporations whose business is to hold interests in other corporations), the regulations will provide for periodic inspections of the books and records of a fund, and require fund advisors to be certain that their funds are adhering to proscribed regulations. In the case of the ordinary business corporation in the United States, federal securities regulators do not usually inspect the actual books and records of the corporation. Instead (and I believe this is true of most other industrialized countries), there exist framework accounting rules set by securities regulators proscribing how the corporation shall keep its books and records and report to its shareholders. In the United States, regulators permit the corporation issuing public securities to hire private auditors who ensure that company “financial statements” accurately reflect true financial condition. The hired auditors inspect and “certify” the financial statements according to their own set of principles, customarily called “generally accepted accounting principles,” or “GAAP”.

There are penalties, of course, for falsifying the books, but there is an enormous amount of space, as we know from the Enron and WorldCom scandals, for wiggle room—or, one might say, varying interpretations of GAAP. The Sarbanes-Oxley legislation²⁶ in the United States and other forms of revised corporate regulation abroad have attempted to deal with some of the problems arising out of this system, trying to ensure that investors are given accurate, or at least not misleading, information about the financial condition of the corporation they have invested in.²⁷ However, the relevance of the Enron episode and its aftermath to this thesis is only that the failure of Enron, although disastrous for

24. See Rosa Lastra, *The Governance Structure for Financial Regulation and Supervision in Europe*, 10 COLUM. J. EUR. L. 49 (2003) (defining “[s]upervision” as “oversight of financial firm’ behaviour, in particular, “Monitoring” and “[R]egulation” as rolemaking”).

25. This term refers to law creating supranational entities that legislate for financial markets and financial market actions headquartered or doing business in the confederation of states they cover. The prime example is the European Union. See *id.* (describing how the EU is legislating financial services regulation).

26. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28 and 129 U.S.C.).

27. Jeff Madrick, *Economic Scene: Where Economists Stand, or Don’t Stand, on the Issue of Corporate Scandals*, N.Y. TIMES, Oct. 28, 2004, at C2 (noting that David A. Sneed of the University of Pennsylvania School of Law thinks that Sarbanes-Oxley did not go far enough and that, among the other reforms proposed in his ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM (2004), he proposes that auditors would be assigned by the stock exchanges themselves).

its employees, pensioners, creditors, and stock holders, did not have systemic implications. The bankruptcies of Enron and Worldcom have not occasioned international financial instability and, in fact, might be said to represent only the government's failure to protect consumers.

Now consider the regulatory/supervisory system for depository institutions or "banks" and their affiliates as best practices in the area as expressed in the Basel Core Principles for Effective Banking Supervision²⁸ issued by the Basel Committee on Banking Supervision ("BCBS") in 1997. First, banks are inspected ("examined") on-site by a regulator corps of examiners. The examination is completed on a regular schedule. Examiners review the books and records required to be on file, as well as mandatory reports (in accordance with accounting rules set by the regulator, or "RAP," not by the accounting profession) to ensure, to the extent possible, that the bank is not skirting any regulation. In addition to the at least annual on-site examination that all federally supervised banks must undergo in the United States, the Fed monitors (from the figures in the required mandatory quarterly Call Reports referred to above) off-site banks for which it is the regulator. To do this, the Fed uses highly sophisticated and rigorously tested electronic systems. "Output from the systems is used to accelerate the on-site examinations of institutions showing financial deterioration, to identify the areas of most supervisory concern in those institutions scheduled for examination; and to allocate the more experienced examiners to troubled institutions." If the examiners, who in the United States are specially trained, find rules violations or simply a financial situation in need of immediate remedial action, the law gives them a panoply of remedial enforcement tools.²⁹ One may ask here, why does such an expensive system of ensuring compliance with law and regulation to say nothing of pre-failure intervention used in connection with banks of deposit when, in the usual case, the failure of an individual bank will not have systemic implications, either nationally, or internationally?³⁰ The answer, of course, has to do with the state subsidy to the banks of the deposit guarantee scheme in the jurisdiction. To the extent that taxpayers are ultimately on the hook for the bank's funding, the government, as the voice of the taxpayers, will insist on influencing business management.

But then we move to the next level, those financial conglomerates (with or without a bank having guaranteed retail deposits at the center)³¹ whose possible

28. BASEL COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (Sept. 1997), at <http://www.bis.org/publ/bcbs30a.pdf> (last visited June 26, 2005).

29. See Rebel A. Cole et al., *FIMS: A New Monitoring System for Banking Institutions*, 81 FED. RES. BULL. 1 (1995).

30. We are not speaking here of depository institutions in emerging markets that fund themselves in the interbank markets in foreign currencies, thus incurring transfer risk and creating considerable risk for their country's macro-economy. See Lichtenstein, *supra* note 1.

31. At the present time, Fed supervision of financial conglomerates is limited to those that do include a depository bank, but as will be recalled from the text at note 17, the supervisor of stand alone U.S. securities

failure is considered by the industrialized countries' central banks to have internationally significant systemic implications.³²

This is the group of entities (at least those with a bank at the center at the time) that the BCBS originally focused on, "large internationally active banking organizations," when promulgating (if such a term may be used for a group with no identifiable legal personality) the Basel Concordat³³ in 1983 and the Basel Accord ("Basel I" and amendments) of 1988.³⁴ This is the group of entities, as

firms, the SEC, has joined in the issuance of the Interagency Paper describing "sound practices" to "strengthen the resilience of the U.S. financial system," the paper that defines "systemic risk" and, in effect, admits that securities firms of the size described in the Paper can also present systemic risk. See also the justification for prudential supervision of large securities firms (as opposed to conduct of business rule-making for consumer protection purposes) in Michael Taylor, "Twin Peaks." A Regulatory Structure for the New Century (Centre for the Study of Financial Innovation 1995), at 4 "Banks have traditionally been seen as the key systemically important institutions. However, as the Promised report of 1992 observed [fn omitted], *a wide range of financial firms can now create potentially systemic problems* (emphasis in the original), given the importance of non-bank financial firms—securities houses, insurance companies, trusts and others—in the OTC ("over-the-counter") derivatives markets, including as market makers in some cases." See also *infra* text at note 45.

This understanding that all forms of financial multinationals, whether or not the conglomerate has a "bank" at its center, may be systemically important has now permeated the work of the international financial institutions, the IMF and the World Bank, to spread implementation of the Basel Core Principles, *supra* n., to their client states. CESARE CALARI & STEFAN INGRES, INTERNATIONAL MONETARY FUND AND WORLD BANK, IMPLEMENTATION OF THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION, EXPERIENCES, INFLUENCES, AND PERSPECTIVES, available at <http://www.imf.org/external/np/mae/bcore/2002/092302.pdf> at 25, ¶ 49:

Developments in financial markets: Three main developments in the financial markets since 1997 need to be taken into consideration in review of the BCPs and the Methodology: continued internationalisation of financial markets, the blurring of boundaries between the traditional financial sub-sectors banking, insurance and securities, and acceleration of financial sector consolidation. All these changes demonstrate an increasing need for cooperation and coordination in regulations and practices between domestic and international financial supervisory agencies to establish a consistent group-wide framework. This would comprise supervisors from different sectors and countries, which can effectively supervise a multinational financial conglomerate.

32. One should note here that at least as of the year 2000, Fed did not seem to be openly justifying the "umbrella supervision" of financial conglomerates applying for financial holding company ("FHC") status under the Bank Holding Company Act 12 U.S.C. § 1842 et seq. as amended by the Gramm-Leach Bliley Act, *supra* note 12, to enable the conglomerates to affiliate with securities and insurance firms given to Fed by the GLB Act on the grounds of international systemic stability. Instead, Fed in its Supervisory Letter issued on August 15, 2000 on its "Framework for Financial Holding Company Supervision," SR.00-13 (SUP), available at <http://www.federalreserve.gov/boarddocs/srletters/2000/SR0013.htm>, August 15, 2000, stated: "The Federal Reserve, as umbrella supervisor, will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of its depository institution subsidiaries." Fed does not spell out the possible consequences of such a lack of "viability," but this paper will be spelling out how the risk based supervision process for "LCBOs" (read "FHCs") certainly tracks the Basel concept of risk-based capital adequacy standards as rearticulated in Basel II, Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A revised Framework and that Fed has announced will only be applied to a "small number of large, internationally active U.S. banking organizations," Joint Press Release, June 26, 2004. The Supervisory Letter is required reading for anyone interested in the issue of Fed as "umbrella supervisor."

33. *Supra* note 22.

34. BASEL COMMITTEE: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (Apr. 1998), at <http://www.bis.org/publ/bcbscl11.pdf> (last visited June 26, 2005).

enlarged by the addition of the groups of systemically important securities houses and equivalent insurance affiliates, for whom the Fed's methods of supervision and examination have changed significantly with the issuance by the Fed in 1997 of its "Handbook" titled: "Framework for Risk-Focused Supervision of Large Complex Institutions," as the attachment to SR 97-24 (SUP) (Oct. 27, 1997).³⁵

The remainder of this paper will concentrate on a detailed, if not overly technical, description of the Fed's new approach to supervising large complex banking organizations ("LCBOs"), whether the entities are headquartered in the United States, with the Fed as the home country supervisor or abroad with the Fed as the supervisor of the U.S. office (host supervisor).³⁶ The rationale for the Fed's development of the new program of supervision should be clear from the perhaps lengthy description previously given and that follows of LCBOs changed role in systemic risk. For an excellent description of both how entities come to be classified as warranting the new approach to supervision and a history of the program's development, one should refer to the paper published in 2001 in the Federal Reserve Bulletin by Lisa M. DeFerrari and David E. Palmer, both of the Fed's Division of Banking Supervision and Regulation (DeFerrari and Palmer).³⁷

The curious thing about this program and its corollary, the special program for supervision of FBOs described in footnote 56, is how little attention the government has paid to the revised—and very different—program of supervision in the legal literature. De Ferrari and Palmer are not law professors, nor does the Federal Reserve Bulletin qualify as a law review, regardless of how useful it is to financial services practitioners seeking background. The author has found only one law review piece that refers to the relevant Supervisory Letters and attempts to describe the new system: Joseph J. Norton, *A Perceived Trend in Modern International Financial Regulation: Increasing Reliance on a Public-Private Partnership* ("Norton").³⁸ Unfortunately, Norton seems to misconceive the purpose and the mechanics of the new supervisory approach because he theorizes a form of regulatory capture of the supervisory authorities by what he calls "elite banks." Norton posits that "... the larger and more influential elite banks have considerably greater financial and intellectual resources at their disposal than the government agencies, in terms of expertise in dealing with increasingly complex

35. Federal Reserve Supervisory Letter SR 97-24 (SUP) (Oct. 27, 1997), available at <http://www.federalreserve.gov/boarddocs/SRLETTERS/1997/SR9724.htm>.

36. Federal Deposit Insurance Corporation Improvement Act (FDICIA), Pub.L. No. 102-242, 105 Stat. 2236, placed supervision of all foreign bank entry, whether directly by offices of the foreign bank licensed by a state banking authority or the Comptroller of the Currency or by the creation of a banking subsidiary chartered by either a state or under federal law, in Fed. As is noted in DeFerrari and Palmer, *infra* note 37, at 55, "... large FBOs account for approximately one third of the banking organizations in [Fed's] LCBO program."

37. See Lisa M. DeFerrari & David E. Palmer, *Supervision of Large Complex Banking Organizations*, 87 FED. RES. BULL. 47 (2001).

38. See Joseph J. Norton, *A Perceived Trend in Modern International Financial Regulation: Increasing Reliance on a Public-Private Partnership*, 37 INT'L LAW. 43 (2003).

and global risk exposures,”³⁹ and he describes the new form of supervision and its oversight of internally generated econometric risk measurement models as “privatisation.” According to Norton, the article “. . . explores the notion of a ‘risk-focused’ supervisory regime coupled with a ‘self-regulatory’ regime (i.e., ‘qualified self-regulation’) [presumably the internal models] as a modern manifestation of and a trend towards ‘a quasi or partial privatization’ of what traditionally would have been the exclusive domain of government.”⁴⁰

Moreover, Norton has not given sufficient credence to the mechanics and staffing of the new form of supervision for LCBOs. In his article, he asks some very good conceptual questions concerning banking authorities’ decisions to intervene (through monetary, supervisory, or regulatory policy) in “periods of systemic risk, distress, crisis and failure.”⁴¹ The paragraph with these questions (replicated) below in footnote 41) ends with the statement: “These questions should be cautiously explored in developing future reforms to large bank supervision and capital adequacy frameworks.”⁴²

This author could not agree more with these conceptual questions, but, contrary to Norton, believes that the Fed’s new system supervising LCBOs, as set out in SR 99-15 (Sup)⁴³ (to be discussed below and as described in De Ferrari & Palmer⁴⁴) has been designed specifically to respond to these questions. It is the thesis of this paper that the new framework, rather than being a “privatisation” of supervision or a “partnership” of the “elite” banks and their U.S. central bank supervisor (the Fed), as argued by Norton, is the attempt by the supervisor to ensure, by its processes and staffing of supervision of LCBOs, that it is setting the supervision agenda for itself, other U.S. supervisors and foreign supervisors, and that it is attempting to ensure the ultimate responsibility of a central bank.⁴⁵

39. *Id.* at 51.

40. *Id.* at 44.

41. *Id.* at 52. These questions are:

First, how and on the basis of what information should elite bank risk management and internal control systems be continuously supervised and evaluated by banking authorities over time? Second, how can the credit, market, and operational risks undertaken by an elite bank be measured and its capital adequacy evaluated in real time? Third, how can elite bank senior management be held accountable for meaningful deficiencies in risk management and internal control systems and for capital inadequacy? Fourth, how should such accountability be defined and determined (in terms of regulatory enforcement or public disclosure or both), and what is the objective of holding persons or institutions accountable? Fifth, what should be the standard for holding such senior management accountable for risk management and internal controls failures that result in substantial losses to the banks and/or jeopardize the national or global banking and financial systems?

Id. at 53.

42. *Id.* at 53.

43. *Supra* note 37.

44. *Id.*

45. See also Karen Shaw Petrou, Address before the Committee on Banking, Housing and Urban Affairs of the United States Senate (June 18, 2003), in *BASEL II: BABY IN THE BATH WATER WORTH SAVING*, available at <http://www.fedfin.com/presscenter/Petrovsenatetestimony061803.pdf>. Granted that Ms. Petrou is in effect a

In conjunction with reading Ms. Petrou's testimony,⁴⁶ one should consider the Fed's Press Release in re Supervisory Letter Concerning Capital Adequacy (July 1, 1999) and its attached Supervisory Letter whose subject is entitled "Assessing Capital Adequacy in relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles," reprinted in "SWAPS and other derivatives in 1999," PLI Corporate Law and Practice Course Handbook Series, November 1999.⁴⁷ The Press Release states that the attached Letter grew out of a "recent supervisory review of internal capital management processes" at several LCBOs. The Press Release also reiterates that "[s]upervisory letters are the primary means by which the Federal Reserve communicates key policy directives to its examiners, supervisory staff, and the banking industry," and states as "the long-term goal[s]" of the attached Supervisory Letter to encourage broader adoption of sound practices in internal analysis of capital adequacy, to promote further innovation and enhancements by the industry in this area, and to integrate better such internal analysis into the supervisory process.⁴⁸

The Letter itself directs supervisors and examiners (the difference is in rank, with the "supervisors" being the officers of the regional Federal Reserve Banks and of the Fed in D.C. who are in charge of the supervision process, and the "examiners" being the government employees who are actually carrying out the examination process on the ground or through the electronic process "... to evaluate *internal* [emphasis added] capital management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the institution's capital needs."⁴⁹ To support such an evaluation, the Letter continues by detailing what it calls "the fundamental elements of a sound internal capital adequacy analysis" as well as "the key areas of risk to be accompanied by such analysis." In particular, examiners, "[u]sing as a guide the elements of sound practice described in this SR Letter," are directed to "evaluate whether the organization is making adequate progress in assessing

lobbyist for the "elite" Norton writes about, this author nevertheless finds her writings analytical and persuasive. In her Senate testimony, Petrou is arguing against the inclusion of a capital charge for so-called "operational risk" in Pillar I of the proposed revised Capital Accord upon which the BCBS has been laboring since 1999. See BASEL COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENTS AND CAPITAL STANDARDS: A REVISED FRAMEWORK (June 2004), available at www.bis.org/publ/bcbs107.htm (last visited June 26, 2005) (Basel II). As Petrou summarizes in her testimony, the three pillars of Basel II are "improved regulatory capital standards, better supervision and more disclosure." Op. Cit. *supra*, at p. 4. She goes to say: "If Pillars 2 and 3 work well, then Pillar 1—the capital standards—need not be as formulaic and far-reaching as currently proposed because supervisors will have ample tools to tailor regulatory capital to individual circumstances and markets will know when this isn't being done." *Id.* The United States has excellent supervisory standards and ample authority "to discipline banks for problems that have nothing to do with capital standards." She concludes (on p. 5): "U.S. regulators, I think, could have done much for the global financial system and avoided many of the pitfalls in Basel II if more attention had been paid to exporting our strict supervisory standards and their effective enforcement."

46. See *supra* note 45.

47. 1147 PLI/Corp 281.

48. *Id.* at 285.

49. *Id.* at 288.

its capital needs on the basis of the risks arising from its business activities, rather than focusing its internal processes primarily on compliance with regulatory standards”⁵⁰ The Supervisory Letter contains highly sophisticated direction as to how a “sound internal capital adequacy analysis” is accomplished,⁵¹ and directs examiners to review a bank’s “analysis, including the target levels of capital chosen, to determine whether it is sufficiently comprehensive and relevant to the current operating environment.”⁵²

One may contrast the Fed’s instructions in this Supervisory Letter issued in 1999 with Norton’s conclusion in his 2003 piece that “[T]he ‘risk-focused supervision’ concept essentially redirects responsibility and accountability for the design, development and implementation of risk management and internal control systems to the elite banks themselves, subject to general and objective (and, at times, subjective) standards for such systems established by the banking authorities, and to supervisory oversight of such systems.”⁵³

The initial Supervisory Letter (SR 97-24 (SUP)) attaching the new “Handbook” titled “Framework for Risk Focused Supervision of Large Complex Institutions,” explains that “[O]ver the last several years, a major strategic initiative of the Federal Reserve has been to develop and implement an examination and supervision program for large domestic and foreign banking organizations that focuses more effectively on an organization’s principal risks and on its internal systems and processes for managing and controlling these risks.”⁵⁴ The Fed further explains that the “. . . best practice in the supervision and regulation of banking organizations is an evolving concept that must continually respond to important developments in banking, . . . the changing nature of risk-taking . . . and the globalization and integration of financial institutions and markets.”⁵⁵ It is notable that this change in the Fed’s conception of supervision and examination applies to *both* large domestic and foreign banking organizations.⁵⁶ The distinction that the Fed now makes in its supervision since

50. *Id.*

51. *Id.* at 291.

52. *Id.* at 296.

53. Norton, *supra* note 38, at 53.

54. Federal Reserve Supervisory Letter SR 97-24 (sup) (Oct. 27, 1997), available at <http://www.federalreserve.gov/boarddocs/SRLetters/1997/SR9724.htm>.

55. *Id.*

56. Supervision and examination of foreign banking organizations (FBO’s) of course, necessitated certain refinements of the new initiative. SR 00-14 (SUP), Oct. 23, 2000 describes the enhancement of “the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations” originally established in March 1995. That program differs from the Risk Focused Framework in that it provides for a process entitled the “Strength of Support Assessment” (SOSA), meaning an evaluation of the organization’s (that is, the foreign banking organization—the top parent abroad, the foreign equivalent of a domestic FHC) “ability to provide financial, liquidity and management support to its U.S. operations.” Federal Reserve Board Division of Banking Supervision & Regulation, Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations, ii. (Aug. 8, 1999), available at <http://www.federalreserve.gov/boarddocs/srletters/2000/SR0014.htm>. The forward to the “Handbook,” see *supra* note 54, in its third paragraph notes specifically that the new initiative in examination incorporates the U.S. operations of

issuing the 1997 Handbook is not between domestic and foreign owned depository institutions, but between "community banks" and LCBOs. As the Forward to the "Handbook" states: "The complexity of financial products, sophistication of risk management systems (including audit and internal controls), management structure, and geographic dispersion of operations are but a few of the areas in which large institutions may be distinguished from community banks."⁵⁷

Interestingly, at the same time that the Fed was developing both its program for supervision of foreign banking organizations in the United States⁵⁸ and its new initiative for risk-focused supervision,⁵⁹ September 1997, William J. McDonough, at that time President of the Federal Reserve Bank of New York, delivered a speech before the Institute of International Bankers. He argued for the Fed as the umbrella supervisor of whatever "financial modernization" Congress might enact (which eventually, in 1999, Congress did with the Gramm-Leach-Bliley Act⁶⁰) on the ground that, as reported by Banking Policy Report, "... financial... conglomerates large enough to threaten the stability of the financial system should, at a minimum, be subject to some form of consolidated supervisory oversight that has market stability as its guiding principle."⁶¹ The Report goes on to say that "McDonough said bank regulators should instead focus on promoting financial market stability and minimizing systemic risk... [rather than protecting the deposit insurance fund]. 'Supervisors need to come up with a contemporary model for overseeing the activities of financial conglomerates,' he said. It has become increasingly difficult for supervisors and the industry to distinguish between the business of banks and securities firms... Given these linkages, the failure of either a major bank or securities firm could have systemic effects on the financial

FBO's, and warns that since the "Federal Reserve is a host country supervisor rather than the home country consolidated supervisor... the risk-focused examination process needs to be carried out within the framework of the FBO program which fully accounts for these differences and was agreed to with other supervisors in 1995." The enhancement to the supervision of FBOs in 2000 carried out the approach of the Risk-Focused Supervision initiative to interaction with senior management of the large institutions the initiative focused on, that is, "... the Federal Reserve and other U.S. bank supervisory agencies have agreed to begin informing both the FBO's senior management and its home country supervisor of the foreign bank's SOSA ranking." The author understands from a former supervisor that not only is the home country supervisor informed of the FBO's SOSA ranking, but that the U.S. supervisors and the foreign supervisors then talk about any discrepancies between the U.S. assessment of the strength of the FBO's finances, liquidity and management and what the foreign supervisor is seeing in *its* supervision and examination. That, however, is another paper for another day.

57. See *supra* note 54, at i (Forward to the attached Handbook available at <http://www.federalreserve.gov/boarddocs/SRLetters/1997/sr9724a1.pdf>).

58. See *supra* note 56.

59. See *supra* note 35 and accompanying text. See also Yokoi-Arai, *The Evolving Concept of Operational Risk and Its Regulatory Treatment*, 9 WTR L & BUS. REV. AM. 105, 118 (2003) (succinctly summing up the change in approach, stating, "The supervisory trend of industrialized countries is evolving from balance sheet assessments to risk-based analysis.").

60. *Supra* note 16.

61. Aspen Law & Business, *Fed Reasserts Position on Designating an Umbrella Supervisor*, 16 No. 19 BANKING POL'Y REP. 8 (1997).

system.”⁶² Thus, both understanding the need for supervision and what the nature of that supervision should be was changing in the late 1990s, not only for the Fed’s most senior officials, but also for perspicacious academics.

In 1995, the Centre for the Study of Financial Innovation, a self-described London “non-profit think-tank,” published a paper by Michael Taylor, formerly with the Bank of England and at that time director of a course in financial services regulation at London Guildhall University, entitled “‘Twin Peaks’: A Regulatory Structure for the New Century.”⁶³ At the time when Taylor’s was preparing his paper, the United Kingdom was debating Britain’s financial supervisory structure; a debate that would culminate, under the leadership of Prime Minister Blair, in a thorough revision of the then Financial Services Act. The Act abolished many of the self-regulatory bodies set up by that Act and shifted bank supervision from Bank of England to a newly formed “Financial Services Authority” (which not coincidentally also took over the functions of the Securities and Investment Board, the former U.K. securities regulator).

Michael Taylor added to the deliberation by stressing in this paper two separate aims for supervising financial intermediaries: “to ensure the soundness of the financial system” and “to protect consumers from unscrupulous operators.”⁶⁴ These two goals constituted the “twin peaks” (quite discrete peaks) of the title of his paper. His thesis suggests that U.K. financial supervision/regulation be divided into two separate agencies, one, the Financial Stability Commission to “ensure . . . the soundness of the system, the capital adequacy of banks and control of risk” and the other, the Consumer Protection Commission to “enforce conduct of business regulation to ensure that the consumer receive[s] a fair and honest service.”⁶⁵

For the purposes of this paper, the most interesting part of “Twin Peaks” is Taylor’s first of four main components of his “. . . *case for assigning responsibility for the financial soundness of all major financial institutions to a single agency*” (emphasis in original).⁶⁶ He lists as those components the ideas that “a wide range of financial firms must now be regarded as systemically important; existing regulatory requirements raise issues of competitive equality . . . ; the rise of financial conglomerates makes a group-wide perspective . . . essential; and finally, there is a need to pool the rare expertise which is necessary adequately to supervise increasingly sophisticated trading operations.”⁶⁷

62. *Id.* In June, 2003, McDonough became the Chairman and Chief Executive Officer of the U.S. Public Company Accounting Oversight Board established by the Sarbanes - Oxley Act of 2002, *supra* note 26.

63. *Supra* note 31.

64. *Id.* at i, The Executive Summary.

65. *Id.*

66. *Id.* at 4.

67. *Id.*

It is this fourth component that is clearly perspicacious. Taylor fleshes out this notion of pooling expertise by writing later in the paper:

A final consideration also derives from the increased emphasis on assessing the adequacy of the internal risk control systems (including value-at-risk models) and the need to understand the global risk profile of complex financial groups. [Footnote omitted]. This is already creating a demand for high levels of expertise on the part of supervisors and regulators - a demand which is likely to expand still further in the coming years. Given the inability of the regulatory bodies to compete with the remuneration offered by the commercial sector, this expertise is always likely to be in short supply. Thus, there is a strong case for pooling the presently thinly-spread regulatory expertise to undertake the difficult task of adequately supervising sophisticated risk management systems and to develop the techniques necessary to come to grips with the issues posed by financial conglomerates.⁶⁸

In a subsequent section entitled, "Governance and staffing of the Commissions," Taylor further explicates his notion of the need for rare expertise amongst supervisors of the systemically important international financial conglomerates:

Each Commission should be responsible for recruiting its own staff, since the knowledge and expertise they will require will be markedly different. The staff of the Financial Stability Commission will need to have (or to acquire) the skills used by auditors and risk management specialists, and should include at least some with the mathematical background to be able to understand and assess the most advance risk management models. By contrast, the Consumer Protection Commission will require staff with a predominately legal or accounting background, including at least a few who are skilled in forensic accountancy. This contrast in skills is already apparent within the regulated firms themselves, where risk management specialists and compliance professionals are involved in different aspects of regulation (prudential and conduct of business respectively).⁶⁹

This same notion of the need for expert staffing of the supervisory teams examining LCBOs, what Taylor calls "complex financial groups," permeates⁷⁰ the Fed's new supervisory system.

68 *Id.* at 11-12.

69 *Id.* at 12.

70. *Cf. supra* note 38, at 49 (stating, "banking authorities also generally lack the expertise or resources available to elite banks and, therefore, have the incentive to seek out the counsel and advice of constituent elite banks on issues pertaining to monetary, supervisory, and regulatory policies prior to or during their implementation").

Turning to the specifics of the new supervision process as explicated both in DeFerrari & Palmer,⁷¹ and in the Fed's 1999 SR letter, "... build[ing] upon the Federal Reserve's existing risk-focused supervision program by providing more specific guidance on the applicability of this program to LCBOs."⁷² DeFerrari & Palmer provide a chart⁷³ comparing traditional bank examinations with risk-focused supervision for LCBOs, one of the differences in the latter system being that "[I]nstitutions are assigned designated supervisory teams. The teams are supplemented with specialists, who may be drawn from across the Federal Reserve System."⁷⁴ The article in the text explains that the assigned designated supervisory team is "a full-time team of Federal Reserve supervisors"⁷⁵ for each LCBO. The team is responsible for developing and maintaining the Fed's "supervisory plan" (the nature of which is explained in the article) for the particular LCBO, and generally comprises four to ten seasoned examiners and analysts. The team for each LCBO is "headed by a very senior examiner or Reserve Bank official" called the "central point of contact" or CPC for the particular LCBO. The CPC "coordinates the development and execution of the supervisory strategy for the institution."⁷⁶ In addition "teams with technical expertise on such issues as credit-risk modeling, payment systems, and information technology are available to supplement individual LCBO teams."⁷⁷

The LCBO's Fed team does not work alone. DeFerrari & Palmer stress that since the lead bank of an LCBO may have a primary supervisor (for example, the Comptroller of the Currency if the lead bank is a national bank or a foreign supervisor if the lead bank in the LCBO is a FBO) other than the Fed, coordination of the team with the LCBO's primary supervisor is very important. The two authors point out that:

"[I]n addition, systemic risk is associated with the potential disruption of the operations of large banks. Thus, the Federal Reserve needs to know more about the activities within large insured depository institutions than can be derived from public information or from the reports of the primary bank supervisor, and it also needs to have more than ad hoc

71. *Supra* note 37.

72. Fed. Reserve Supervisory Letter SR 99-15 (SUP) (June 23, 1999), *available at* [http://www.federalreserve.gov/boarddocs/SR letters/1999/SR 9915.htm](http://www.federalreserve.gov/boarddocs/SR%20letters/1999/SR%209915.htm).

73. DeFerrari & Palmer, *supra* note 37, at 51.

74. *Id.*

75. *Id.* at 53.

76. *Id.* The author was informed by a former examiner that not a business day goes by without some member of its team being present at Citibank. Given this level of supervision and examination, one may ask why the asset management business in Japan managed to do so violate Japanese law that it was expelled from Japan. See Timothy O'Brien & Landon Thomas Jr., *It's Cleanup Time at Citi*, N.Y. TIMES, Nov. 7, 2004, § 1, at 1. Perhaps the answer is simply that "private banking," managing the money of very rich individuals, does not entail "systemic risk," however much violation of Japan's consumer protection regulation may put Citibank's reputation at risk, and so was not within Citi's team's remit.

77. *Id.* at 50.

contact with the primary bank supervisor. Similarly, the primary bank supervisor needs information about the activities of a bank’s parent company and its nonbank affiliates to be aware of, and address as a necessary, threats to the soundness of the bank that may arise from elsewhere in the consolidated organization.”⁷⁸

Thus, in effect, the Fed seems to consider itself the lead LCBO supervisor, regardless of the legal structure of the organization. DeFerrari & Palmer continue their piece by describing the Fed’s own structural changes to ensure that it has the capacity to support adequately its LCBO teams. They describe Coordinated Supervisory Exercises, as essentially a kind of internal simulation of an examination or sharing of knowledge from examination work at a number of LCBOs intended to deepen understanding of inherent risk in specific business activities, develop examiner expertise, and identify gaps and weaknesses in existing Federal Reserve System policies and procedures.⁷⁹

In addition DeFerrari & Palmer describe the establishment of competing centers, housed at designated Reserve Banks, and intended to “. . . develop and maintain Federal Reserve System expertise in specific technical areas in an efficient manner.”⁸⁰ The resemblance between these descriptions of the Fed’s supervisory process for LCBOs and Michael Taylor’s proposed Financial Stability Commission is obvious.

As for the Fed’s own SR Letter on the subject, SR 99-15 (SUP),⁸¹ much of its content has been already covered by the description of DeFerrari & Palmer.⁸² What the Letter adds is its specific statement⁸³ that the new emphasis on assessing internal policies and processes for identifying, measuring, monitoring, and controlling risks is *in addition* to “sufficient transaction testing to determine a financial institution’s compliance with sound banking practices”⁸⁴ This paper began with the observation that the “ordinary business corporation is not in the ordinary course examined at all and that the truthfulness of the data it releases to its regulators and the public depend upon the after-the-fact criminal penalties for fraud and lying.” One hopes that this paper has demonstrated that, at least for

78. *Id.* at 54. In this connection, consider what Fed has to say in SR 00-13 (SUP), *supra* note 32, about what supervisory staff may do with respect to obtaining a “specialized report” from a “functionally regulated subsidiary.” Essentially, a regulator is speaking for the SEC in the case of an investment bank subsidiary of the conglomerate. *Id.* at 6. The regulator outlines the circumstances under which Fed “may examine,” that is, send its own staff in, such a subsidiary. *Id.*

79. DeFerrari & Palmer, *supra* note 37, at 56.

80. *Id.*

81. *Supra* note 72.

82. See generally DeFerrari & Palmer, *supra* note 37.

83. Contrary to the allegation in Norton, *supra* note 38, that the “Base Commit other systemically important conglomerates have redirected “examination techniques to emphasize risk management and internal central systems, as opposed to determining through transaction testing and other static means whether a bank or LCBO is operating in a safe and sound manner at a given time.” *Id.* at 46.

84. SR 99-15 (SUP), *supra* note 72, at 2.

those financial conglomerates that are classified by the Fed as LCBOs because of the importance of their safety and soundness to international financial stability, exactly the opposite is true. The Fed has tried to develop a supervisory framework with its LCBO supervision program that is sufficiently flexible and grounded in the supervisory system's expertise so as to keep the supervisor genuinely in touch with the on-going risks of the business of each LCBO so supervised and in control of the efficacy of the institution's own internal models of risk management. So far, it has worked. One can only hope that the system will continue to do so as these LCBOs, representing the circulatory system of the global financial markets, meet greater and greater financial stability challenges.

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